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The influx of the additional money into the system always takes place at some particular point. Who these people are will depend on the particular manner in which the increase in the money stream is being brought about. It may be spent in the first instance by government on public works, or it may be first spent by investors mobilizing cash balances or borrowing for the purpose; it may be spent in the first instance on securities, on investment goods, on wages or on consumers' goods. It will then in turn be spent on something else by the first recipients of the additional expenditure, and so on. The inflation process will take very different forms according to the initial source or sources of the additional money stream.

Can We Still Avoid Inflation
Friedrich A. Hayek

Profitless Paper Prosperity

Although investors and speculators have been charging into cyclicals, the present reality is that most economies are still getting worse, not better. "The balance of risk remains on the downside," said the Research Director of the International Monetary Fund, when presenting the institution's forecast of 2.3% global economic growth in 1999 and 3.4% in 2000. Major imbalances and structural dislocations in the world economy are hardly rectified. The new explosion of the U.S. trade gap, up 65% against a year ago, suggests the opposite.

With the sudden advance of lagging stocks and industry groups, there's excited talk of a great rotation into value. And with the hypersensitive, performance-driven crowd clutching at every apparently bullish straw, the perception of a recovering global economy has hit a very captive audience. We firmly believe that this new bull run on Wall Street and around the world has little to do with finding value but has everything to do with frenzied speculation in desperate quest of making money. Almost overnight, a whole new legion of stocks and groups were in play.

It took only two days for Boeing to advance 25% and four days for Caterpillar and Alcoa to gain about 30%. Such gains are a mockery of economic developments, as the U.S. economy is sure to slow sharply this year. Instead, we see market dynamics as the overriding influence and they point, directly to derivatives—more about this later in this letter—and the sophisticated trading strategies utilized by the highly leveraged speculating community.

To quote Alan Abelson:

> *Forget about what they say, in their hearts; Alan Greenspan, Alice Rivlin, Robert Rubin, Lawrence Summers and other less-celebrated stalwarts who fashion economic policy are vividly aware of the stock market's key role in keeping the expansion alive and well. Truth be told, they're obsessed by the awful knowledge that if the stock market goes, the economy goes and likely the world as well.*

With this in mind, we keep a close watch on the U.S. economy and its escalating imbalances. In this letter we will extend our critical analysis of the U.S. credit bubble, eliciting many new aspects. Our particular focus is on four subjects: (1) the disappointing profit trend in this cycle and massive profit-enhancing management tricks to bolster them; (2) productivity growth; (3) paper wealth versus real wealth; and (4) the exploding derivatives bubble and its inherent dangers.

TOO MUCH STATISTICS, TOO LITTLE THEORY

It is our long-held view that the biggest worry for the world economy at this juncture does not lie in Europe, Asia or Latin America but in the bursting of the U.S. credit bubble economy. It's both inescapable and overdue. Only the timing of that burst and the magnitude of the damage that it will do to the economy and the financial system are uncertain. The damage, essentially, depends primarily on the scale of the prior credit excesses and attendant economic and financial dislocations in the economy. Since the United State's excesses are absolutely atrocious and pervasive, we anticipate savage reverse effects when the bubble finally bursts.

In a recent article, Prof. Paul Krugman discarded any such arguments with the words: It's paper gains today, paper losses tomorrow: who cares? The thing to understand, he continues, is "that a stock market boom is not like a boom in physical investment—say, a boom in condominium construction. That kind of boom depresses future spending because it leaves behind a landscape littered with unsellable condos." A recent Barron's article, "Not to Worry: Credit is Booming, But it's Being Put to Good Use" from Gene Epstein took the same line. He argues the accelerated borrowing of the past few year has caused no irrational exuberance in consumer and capital goods.

As a matter of fact, Greenspan himself has repeatedly spoken of "inflationary imbalances" in the U.S. economy. But how do you identify and measure such imbalances? That's the question, and the short answer is that this indispensably requires a concept of the essential conditions of equilibrium in the economy and its financial system to begin with. Such a concept was at the heart of classical economics. "*On the whole one can say that the practical value of statistical research depends primarily on the soundness of the theoretical conceptions on which it is based,*" according to Friedrich Hayek. Today's reality, in particular in America, is that there is an overabundance of the most detailed statistics but a complete absence of knowledge of the requirements of economic and financial equilibrium.

The most important element of economic equilibrium is the balance between credit expansion and available savings. Credit in excess of savings is the villain that leads to boom and bust because it generates unsustainable misallocations in the use of resources. In short, the measure of non-inflationary credit growth is available savings. This belief that there must be an equality between new credit and new savings used to be the cornerstone of economic theory.

THE FOUR TYPICAL BUBBLE FEATURES

What distinguishes a "bubble economy"? It regularly develops four decisive features: first, money and credit expand vastly in excess both of savings and GDP growth; second, inflationary pressures are channeled to, and concentrated in, asset prices; third, low or falling consumer and producer price inflation keep monetary policy too loose; fourth, soaring asset prices overstimulate domestic borrowing and spending. All four bubble features were strikingly evident in the late 1920s in the United States and, in the late 1980s in Japan. And all four have been strikingly evident again in the United States since 1996.

Identifying a credit bubble starts with a simple juxtaposition of credit growth and current savings. Last year in the United States, aggregate borrowing by consumers and businesses was nearly $1 trillion dollars, compared with virtually zero savings. By these two measures, the present U.S. credit bubble unquestionably ranks as the worst in history.

The next step, then, is to analyze the pattern of the bubble effects on the warp and woof of the economy and its financial system. These are contingent upon how the credit inflation is used. In the case of Japan, the asset bubble had only relatively small effects on consumer spending. The bubble-related surge in private spending centered overwhelmingly on investment expenditures, both buildings and industrial plants.

A strong propensity of credit excesses toward financing investment spending is, indeed, the traditional pattern in the world. But it is by no means compelling. As the introductory quotation from Hayek suggests, the pattern of a spending spree may greatly vary. It may as well converge upon government or consumer spending. In the U.S. case, the biggest credit outlets were consumption and financial speculation. This unusual pattern certainly has a variety of reasons, but a most important one, we presume, lies in the fact that America's outsized financial system is singularly geared towards these two areas. America has, without question, the most efficient system in the world to borrow, to lend, to consume and to speculate.

The most spectacular imbalances in the U.S. economy are the collapse of savings and the soaring trade deficit. But in America, who cares? The savings downfall is discarded as irrelevant, being abundantly substituted by the

wealth effects from the stock market boom, while the huge and soaring trade gap is hailed as testimony to the U.S. economy's underlying strength.

Another comforting delusion. The intrinsic cause of the big and soaring trade gap in the United States is the egregious savings deficiency. In the past, Germany and Japan had chronic trade surpluses for many years against the backdrop of very high investment rates and strong economic growth, and the reason was that they saved even more than they invested domestically. Since high-growth economies ordinarily have both high investment and high savings ratios, this is, indeed, the normal pattern.

Historically, high savings ratios have always gone together with high investment ratios, strong trade balances, high productivity growth, low interest rates and low inflation in the long run. This was true in the America of the 1920s. High-consumption and low-savings countries, on the other hand, have exactly the opposite qualifications on all these counts, as in the America of the 1970-80s. What about America of the 1990s with zero personal savings?

JUST PAPER WEALTH

It should be clear from these brief observations that capital gains from asset price appreciation are definitely no substitute for savings out of current income because there is no release of resources. On the contrary, to the extent that such paper wealth creation fosters higher consumer spending at the expense of savings, it intrinsically impairs capital formation and, consequently, long-term economic growth by absorbing resources that would otherwise be available for funding productive investment spending. In essence, it is capital consumption. Lawrence Lindsey, former governor of the Federal Reserve a and lonely voice of reason in America, recently wrote: "By far the greatest cause for worry is the low rate of savings in the United States."

During 1995-98, the market value of the equity holdings of private households has almost doubled, from $3.3 trillion to $6.3 trillion. Conventionally, this is called wealth creation today. It unquestionably has correspondingly enriched the owners of these stocks. But in economics, the term "wealth creation" used to be confined to genuine capital formation in the form of additions to the economy's tangible, productive capital stock, resulting from the confluence of savings and investments. Any rise in asset prices, not paralleled by the creation of income-earning productive capital, was derogatorily discarded as paper, pseudo or imaginary wealth.

Those are the fundamental and theoretical aspects. Now to the numerical facts, all in billions of dollars.

From the perspective of equilibrium, as earlier explained, this table is an economic and financial horror picture: a literal credit explosion has taken place in the face of a collapsing personal savings. It really is the ultimate in credit excess or credit bubble that the world has ever seen. Yet America's financial establishment continues to rave about the arrival of a "new era" and a "miracle economy" that is prone to generate unprecedented prosperity as never before far into the future.

U.S. SAVINGS VERSUS CREDIT EXPANSION
(IN BILLION US$)

	1992	1993	1994	1995	1996	1997	1998
PERSONAL SAVING (NIPA)*	264.1	248.5	176.8	179.6	158.6	121.1	79.0
CREDIT MARKET BORROWING BY							
(1) NONFINANCIAL SECTORS	522.5	587.1	577.1	703.4	720.3	736.9	952.5
(2) FINANCIAL SECTORS	244.0	294.4	468.4	456.2	552.1	652.8	1116.0
TOTAL FLOWS OF CREDIT	766.5	881.5	1045.5	1159.6	1272.4	1389.7	2068.5
GROWTH OF BROAD MONEY (M3)	11.4	65.4	74.7	262.0	335.5	445.7	605.7
GROWTH OF NOMINAL GDP	327.7	313.7	388.9	322.6	392.0	449.3	399.8

*NATIONAL INCOME AND PRODUCT ACCOUNTS (NIPA'S)
SOURCE: FEDERAL RESERVE, FLOW OF FUNDS ACCOUNTS.

MR. GREENSPAN'S ODD ECONOMICS

It does not surprise us that the great majority of economists in the financial community produce a lot of economic nonsense to keep pushing financial asset prices higher and higher. They know every trick that tends to boost share prices, but they know next to nothing about essential fundamentals of *long-term* economic growth and financial stability. However, there is one person who continues to shock us with his comments about the marvels done to U.S. prosperity by the booming stock market in general and the abundant use of derivatives in particular. And that person is Alan Greenspan.

When the U.S. stock market boomed in the late 1920s and, in the same vein, when Japanese asset markets surged in the late 1980s, the responsible central bankers in both countries followed these booms with strong misgivings. Not so Mr. Greenspan. He is the first central banker who apparently relishes not only the booming stock market, but what's more, its vigorous, galvanizing impact on consumer and business spending as well. Obviously, it does not occur to him that these effects on the economy are precisely the characteristics of a bubble economy.

The following paragraphs are an excerpt from his testimony on Jan. 20, 1999, in Congress. To us, they made frightening reading because they reveal the leading central banker in the world as a person who has unreservedly chimed in with Wall Street's populist spin of a "New Era" for the U.S. economy.

> Parenthetically, improved productivity probably explains why the American economy has done so well despite our oft-cited subnormal savings rate. The profitability of investment here has attracted saving from abroad, an attraction that has enabled us to finance a current account deficit while maintaining a strong dollar. Clearly, we use both domestic saving and imported financial capital in a highly efficient manner, apparently more efficient than many, if not most, other major industrial countries.
>
> While discussions of consumer spending often continue to emphasize current income from labor and capital as the prime sources of funds, during the 1990s, capital gains, which reflect the valuation of expected future incomes, have taken on a more prominent role in driving our economy.
>
> The steep uptrend in asset values of recent years has had important effects on virtually all areas of our economy, but perhaps most significantly on household behavior. It can be seen most clearly in the measured personal savings rate, which has declined from almost six percent in 1992 to effectively zero today.
>
> Arguably, the average household does not perceive that its saving has fallen off since 1992. In fact, the net worth of the average household has increased by nearly 50 percent since the end of 1992, well in excess of the gains of the previous six years. Households have been accumulating resources for retirement or for a rainy day, despite very low measured savings rates.
>
> The resolution of this seeming dilemma illustrates the growing role of rising asset values in supporting personal consumption expenditures in recent years. It also illustrates the importance when interpreting our official statistics of taking account of how they deal with changes in asset values.

PRODUCTIVITY AND PROFIT DELUSION

So, Greenspan thinks that America can prosper with less savings than other countries because U.S. corporate management is making more efficient use of labor and capital than the rest of the world. Well, for all the talk that American productivity is a miracle, Germany's productivity has actually grown more than twice fast as the United States' over the last decade. That is, by an annual average of 2.5%, as against barely 1% in the United States.

Yet the American bulls seize on the fact that U.S. productivity growth has accelerated during the last two years, contrary to the characteristics of the late phase of the cycle, when the economy usually begins to slow. True, but this time, growth has—uncharacteristically—not slowed, which suggests a mere cyclical rather than structural

improvement. In Germany, during these same two years, annual productivity growth averaged 2.7% in the economy as a whole and 6.7% in manufacturing, even with subpar economic growth. Across Europe, by the way, long-term productivity growth has averaged about 2% per annum. The only area where America clearly outperforms Europe is in job creation, but that has been true for the entire postwar period.

Another development, though, seems considerably more important for the higher productivity gains — the vigorous expansion of high tech production. Since 1995, the rapid growth of the computer industry with merely 3-4% of total employment has contributed up to 30% of real GDP growth. Essentially, this implies a correspondingly disproportionate contribution of this small sector to the economy's overall productivity gains. If the computer industry is removed from the calculation of real GDP growth, productivity gains would look much more subdued. The further beauty of this big high-tech contribution to economic growth is that the dizzying fall in computer prices has substantially subtracted from the inflation rate recorded in the GDP price index (used to calculate real GDP from nominal GDP).

Last but not least, productivity growth has been substantially enhanced by way of downward revisions in the calculation of the inflation rate since 1995. With a given growth rate in nominal gross national product, any lowering of the inflation rate works out as a corresponding increase in real GDP, essentially implying a corresponding productivity gain.

If there were an exceptional acceleration in productivity growth, there should have been exceptional profits. On the face of it, the rise in U.S. profits between 1992-97 far exceeded the normal cyclical pattern. Pre-tax profits soared in these five years by altogether 81%, or 16% at annual rate, compared with mean long-term growth of 6%. Wall Street readily seized upon this stellar profit performance as conclusive proof of its claim that high tech and massive corporate restructuring was working productivity and profit miracles on the economy, heralding more of the same in the long run. Inherently, this perception did lend powerful support to Wall Street's postulate that such a steep uptrend in profits justified much higher stock valuations than in the past.

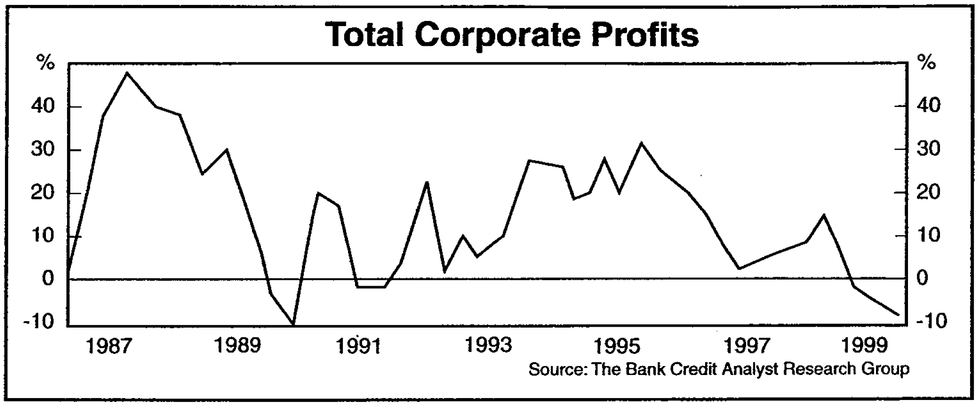
<u>CHART: S&P 500 EARNINGS</u>

A detailed analysis of the sources of the sharp profit growth during those years reveals, however, a much weaker underlying profit performance. The unappreciated fact is that U.S. corporate profits received a strong boost in the first half of the 1990s from three one-off developments. Most important among them was a plunge in net interest charges. Further boosts came from a drop in the effective tax rate and slow growth in depreciation, reflecting the prior sluggish growth in the capital stock. Adjusted for these three factors, profit margins increased by no more than within the range of past cyclical upturns. These three factors essentially provided a temporary supercharge to corporate earnings.

In its April issue, the *Bank Credit Analyst* has published profit calculations which fully expose the story of a "profit miracle" of the 1990s as complete nonsense. Earnings before those three mentioned factors—that is, earnings before interest, taxes and depreciation (EBITD)—increased in these years at an average annual rate of 5.4%, as against 6% average annual nominal GDP growth. True, those benefits were genuine, but importantly, they were temporary and had nothing to do with a productivity miracle. A "new era" of productivity and profit growth would have to show up in the EBITD measure of profits. It didn't.

In fact, profit *growth* (see chart) had already started to decline in 1995, even though economic growth accelerated. While corporate earnings have gone nowhere since the third quarter, the Dow has soared from 7,500 to 10,600. With profits flat since then, the continuing surge in stock prices must be reflecting skyrocketing stock market valuations, even with the collapse of savings.

More than anything else, it is the mediocre profit performance which, in our view, has been putting the lie to the



tale of a U.S. productivity miracle. On the contrary, it appears most ominous that corporations today are struggling to show little if any earnings growth even in a booming economy. There is no profit miracle now, and neither was there one in the past years. With profit expectations still sky-high, this sets the stage for sharply lower equity prices, even if interest rates fall, as they will.

We must admit that we have been warning about weak profits and their negative impact on the stock market for almost three years. As to the actual profit performance, we have been perfectly right, but so far, for various reasons, the investing public has refused to worry about profit deterioration and the effects it could have. Early last year, analysts' bottom-up forecasts called for a 19% increase in profits. Recently the Commerce Department reported a decline by 2%.

Yet these analysts started the current year with a call for a 20% rise in profits. Lately, it is down to 16%, still a stunning projection given that nominal GDP growth will be barely 5%.

The analysts who carry the consensus readily believe that last year's profits weakness was just an aberration, attributable to temporary effects from the Asian crisis. But in fact, the aberration from the underlying weak trend was actually the prior profit boom caused by the already mentioned special factors that were completely unrelated to corporate efficiency.

The principal reason of the poor profit performance is the fact that there is no economic miracle. It was a mirage of a miracle provided by the regular originator of bubble economies: unbridled credit excesses. The table on page 3 tells it all. Booming domestic demand, the buoyant stock market and falling interest rates are perfectly consistent with the rampant money and credit growth that has occurred in these years.

NOW AMERICAN ZAITEKKU

A final point to consider is deteriorating profit quality. Even the mediocre EBITD profits are heavily flattered by the spreading use of dubious accounting practices and financial engineering. During Japan's bubble years it was known as zaitekku—a word marrying the Japanese for "finance" and the English "technology." In the late phase of the bubble, when profits began to lag, Japanese corporations had increasingly turned to financial speculation as a profit source. Now U.S. corporations are, too. Their most widely used ploys involving huge sums are (1) large write-offs, (2) spreading use of stock options as part of employee compensation, and (3) gambling in options on their own stocks.

(1) Write-offs. In his latest annual report to shareholders, Warren Buffet launched a scathing attack on this practice as a widespread device of American management to manipulate profits. 'The distortion du jour," he wrote, "is the restructuring charge, an accounting entry that can, of course, be legitimate but that too often is a device for manipulating earnings ... Clearly the attitude of disrespect that many executives have today for accurate reporting is a business disgrace." Announcing restructuring and mergers, companies dishonestly overstate one-off charges, a practice that reduces their future expenses and therefore flatters later earnings.

(2) Employee stock options. The beauty of using stock options is that this growing part of employee

compensation is not charged as expenses to the corporate P&L account, though they definitely are labor costs. As a result, profits are correspondingly overstated, while employment income and costs are correspondingly understated. A new study by Smithers & Co. Ltd., London, about the impact of the use of options on profits came to the conclusion that if corporations had accounted properly and fully for the costs of options, published profits would have been reduced by a whopping 56% in 1997 and 50% in 1998. Adjusted for the true cost of options, the S&P had a P/E ratio of nearly 55 at the end of 1997 and 63 at the end of 1998. Microsoft, the software giant, by the way, has handed out a stunning $60 billion of option benefits that have never touched its profit and loss account.

(3) **Option trading.** More and more firms have been vastly improving their profits by buying and selling put and call options on their own stocks with profits running in single cases to billions of dollars. In the case of Dell Computer, profits from option writing in the last years have substantially exceeded the profits from computer sales.

THE KEY MONETARY VARIABLE: CREDIT, NOT MONEY

Turning back again to the table on page 3, we draw attention to the escalating discrepancy between money and credit expansion. As described in the last letter, the very same phenomenon occurred in the late 1920s in America. In both cases, it reflects the same thing: a massive shift in credit creation away from the banks towards the money and capital markets and non-bank financial institutions.

This discrepancy occurs because only bank lending creates additions to the money supply (in the form of bank deposits). Traditionally, it has been a widely-held view that only bank credit, alone involving money creation, is of inflationary nature. Hence the focus on the money supply. Actually, this distinction between bank credit and other kinds of credit made sense in the past, as long as securities markets were overwhelmingly funded by the savings from individual investors. But it doesn't make sense anymore in a world of infinite carry trade and repo financing of holdings of securities. All these and similar sources of finance today represent inflationary credit creation, pure and simple, completely uncompensated by new savings.

The highly diversified American financial system is, of course, the tops in this respect. Last year, it managed to manufacture about $1 trillion dollars of new credit for consumers and businesses in the virtual absence of any new savings. While credit creation by banks increases the money stream by adding to the money *supply*, credit creation outside the banking system does so through increasing money *velocity*, implying a more intensive use of the existing money supply, showing no trace in the money statistics. For sure, this ability of infinite credit creation without money creation testifies to a superior efficiency of the U.S. financial system in this respect. Unfortunately, it is efficiency in the wrong place.

Once we recognize the compelling conclusion that must follow is that the thing to be explored and to be analyzed is total credit growth, not the growth of the money supply. Looking for credit *inflation*, we have to measure credit expansion in excess of available new savings. Now we need to ask how much of the new purchasing power from the credit creation flows into the economy (causing inflation in the prices of goods and services), and how much flows into the asset markets (causing price inflation there).

In the last letter, we described the unbelievable credit excesses in the United States that preceded the stock market crash of 1929 and the following prolonged depression. Most of the borrowed money ended up in the financial markets. Considering the collapse of private savings in particular, we suspect that today's excesses are probably even worse. Reading Greenspan, we have to conclude that he sees the imbalances, but like the rest, he fails to understand their intrinsic implications.

One remark of his that particularly shocked us is that "households have been accumulating resources for

retirements or for a rainy day, despite very low measured savings." It is unbelievable to hear this from the world's leading central banker. What's happening with the booming stock market is not a surge in the economy's capital resources but a surge in the value of titles to the corporate capital stock which is increased solely by new investment adding to the productive capacity of this capital stock. If the rise in the value of these titles, as we have earlier explained, leads to substantially higher consumer spending, this absorption of resources, implying capital consumption, tends to reduce future growth.

U.S. BUBBLE ANATOMY

It seems that the conjunction of strong economic growth and falling inflation has more than anything else conjured up the perception of a U.S. economic miracle. To those whose knowledge of history begins and ends with the inflation years of the 1970s-80s, we have to say that this pattern has more often than not been the rule in history. During the great global economic boom of 1952 to 1965, U.S. inflation rose at an annual rate of little more than 1%. Truly exceptional in the present U.S. experience are the stratospheric rise in stock prices with corresponding huge paper wealth effects, and the underlying explosive credit and debt expansion vastly in excess of economic activity.

Earlier in this letter, we stated that an evaluation of a bubble economy has to focus on two key questions: first, how big is the excess of credit expansion over available savings? And second, to what use has the credit expansion been put? That is, how much of it went into the economy, and how much into the financial markets?

Last year, net new borrowing by U.S. consumers and businesses amounted to $925 billion, sharply up from $667 billion in 1997. Borrowed money is sure to be spent. Nobody borrowes in order to keep the money idle. But on what is it spent?

We note that $340 billion was spent on goods and services, as indicated by corresponding output and income growth. Another $80 billion flowed abroad, as reflected in the increase of the current account deficit. This leaves about $500 billion of net new borrowing and spending that has involved no income creation. Essentially, this amount went largely into the financial markets. Keynes would have said into the financial circulation outside the gross national product. Just consider that corporate debt-financed net repurchases of shares amounting to $262 billion last year. That is, about one third of the new borrowing fueled GDP and income growth, while more than one half fueled asset price inflation.

The bulls believe that Greenspan is determined and able to keep the U.S. credit machine running at full speed with interest rate reductions, once they appear necessary. But "full speed" is not enough. The unappreciated dilemma is that sustainting the momentum both in the economy and in the stock market, requires ever-larger credit injections. Over the last four years, the collapse of the personal savings rate has played a crucial role in boosting consumer spending. But just maintaining consumer demand growth, requires dissaving at an ever-increasing rate. If households decided to stop at a zero savings rate now, spending all they earn but no more, the U.S. economy would quickly slide into recession. This trend is absolutely unsustainable, that is the thing to see.

COURTING DISASTER THROUGH DERIVATIVES

If Greenspan's recent, enthusiastic comments about the beneficial effects of the stock market boom on the economy stunned us, his recent enthusiastic speech about the beneficial effects of derivatives on wealth creation have absolutely shocked us. Appearing before the Futures Industry Association, Greenspan emphasized the crucial role of derivatives, stating: "By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives."

According to Greenspan, U.S. commercial banks ended 1998 with outstanding derivative positions of $33 trillion, of which $29 trillion were privately arranged over-the-counter contracts, hence, outside government or exchange regulation. This compares to $460 billion of total equity for the American commercial banking industry.

He also estimates that total global OTC derivative positions now likely approaches $80 trillion, having grown at a 20% compounded rate since 1990. The International Swaps and Derivative Association recently reported that outstanding interest rate swaps, currency swaps and interest rate options grew 76% year-over-year, to more than $50 trillion.

Despite the derivatives debacles in Asia and Russia, U.S. bankers are demonstrating ever more eagerness to expand this businesses. Indeed, their derivative positions have increased by 30% over the past tumultuous year. Chase Manhattan, the largest U.S. bank, with $22 billion of shareholder's equity and $366 billion of assets, increased its total derivative positions 34% in 1998, to more than $10 trillion. As shocking as it is that the banks have not re-evaluated the expediency of such pell-mell expansion of derivative exposure, Greenspan's incessant blessing of their efforts is simply unimaginable. More than an ever he appears as a devoted proponent of derivatives, hailing them with the words: "The reason that [derivative] growth has continued despite adversity, or perhaps because of it, is that these new financial instruments are an increasingly important vehicle for unbundling risk...In short, the value added of derivatives themselves derives from their ability to enhance the process of wealth creation."

For years now, Greenspan has propagated the expansion of unregulated derivative markets, seemingly as some type of wonderful alchemy created from the combination of deregulation, advancement in computer and communication technologies and "new era" financial innovation. Somehow, not even the collapse and subsequent bailout of Long Term Capital Management, with its massive derivative book, has lessened his enthusiasm. His sanguine view of the great benefits arising from derivatives is certainly captured in the following text drawn from his testimony last October before the U.S. Senate.

> A vast new array of debt, equity and hybrid instruments, as well as newly crafted derivative products have fostered an unbundling of risks, which, in turn, has enabled investors to optimize (as they see it) their portfolios of financial assets. This has engendered a set of market prices and interest rates that have guided business organizations increasingly toward producing those capital investments that offer the highest long-term rates of return, that is, those investments that most closely align themselves with the prospective value preferences of consumers. This process has effectively directed scarce savings into our most potentially valuable productive capital assets. The result, especially in the United States, where financial innovations are most advanced, has been an evident acceleration in productivity and standards of living, and, owing to the financial sector's increased contribution to the process, a greater share of national income earned by it over the past decade.
>
> The new financial innovations, which have spread at a quickened pace, have facilitated a rapid expansion of cross-border investment and trade, and almost surely, as a consequence, a significant increase in standards of living for those nations that have chosen to participate in what can appropriately be called our new international financial system.

Well, we doubt many government officials or citizens in Asia, Russia or Brazil would see derivatives in such a positive light. In fact, a recent report from the World Bank stated that losses on OTC derivative contracts since the beginning of the Asian crisis may be as much as $133 billion, and this estimate includes only losses in Russia, Indonesia, Thailand and Russia. The World Bank estimates that losses in Russia alone could run as high as $90 billion. During the same Senate testimony Greenspan stated, "Russia is not large in the world's trade accounts or critical to the stability of the international financial system."

It often appears that Greenspan is so enamored by the sophistication and theoretical concepts behind financial innovation and engineering that he fails to comprehend the essence of the unprecedented excesses and distortions with which derivatives are inarguably a leading factor in precipitating a coming disaster. As such, we understand why some have dubbed him the "Mad Scientist."

There is obviously a connection between his exuberant view of the U.S. economy and his support for the reckless expansion of derivatives. In both analyses, he chooses to ignore that the explosion of credit is the paramount

We suspect that this type of derivative-related buying has provided much of the fuel behind the spectacular blow-off in the Internet and technology stocks and, as well, the Dow and S&P500 where the greatest volume of derivative trading occurs. Indeed, the proliferation of call option buying by companies, institutions, the hedge fund community and, more recently, the day trading community has created potentially massive hidden leverage that powered the rally but which also holds the potential to exacerbate the next decline.

Creating and selling derivatives during bull markets is a highly profitable business. For years, it has been like writing flood insurance during a long drought. But don't be fooled; derivatives are only good in a bull market. They work splendidly when prices rise and their most favored use is leveraged speculation. No doubt, they have been a great factor fueling the American bubble. Unfortunately, they breed disaster when a bear market strikes. Then, the same dynamic hedgers that have fueled the self-feeding rise will reverse course and dump stocks leading to self-feeding decline. Moreover, the likelihood of collapse is exacerbated as panic buying of derivative insurance forces additional selling pressure on the market. Here, as was the case already in 1987 and last year in Southeast Asia and Russia, they hold the potential to create a devastating debacle.

CONCLUSIONS:

Central bankers the world over have been working diligently to reflate—with furious effect on world financial markets, but dubious effects on the world economy. Derivatives play a rapidly growing role. The point is, when a serious market decline comes, there will be little liquidity.

Although several countries are showing varying degrees of improvement, global excess capacity continues to increase because the modest actual recoveries everywhere considerably lag *potential* growth. By this measure, the world economy continues to sink. Globally, the negatives heavily outweigh the positives. If you shade your eyes from the blinding lights of the dazzling equity markets, you recognize a frightening development.

The wild card is the U.S. economy. While the consumer is setting ever-new spending records, a soaring share is bypassing U.S. manufacturers and heading straight for imports. At the same time, capital spending is dropping off. Capacity utilization in manufacturing, at 79.3%, is at its lowest since early 1992. This is the opening of the U.S. economy's slide into recession. Without the abundant use of financial gimmicks, profits would have plunged disastrously.

The belief that global financial problems have been fixed by recent interest rate cuts, or, are at least under control, will be increasingly tested in coming months. The truth is that these cuts gave credit and speculative excesses in the financial markets a strong, new boost.

It is obvious that the U.S. economy has been overheating during the last two to three years despite falling inflation rates. But when the three interrelated bubbles—credit, stock market and economy—eventually burst, it will essentially spell lower inflation and lower interest rates. The next major move of U.S. interest rates will be sharply down.

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